SENATE BILL REPORT SB 6359

As Reported By Senate Committee On: Labor, Commerce, Research & Development, January 26, 2006

Title: An act relating to ensuring employers do not evade their contribution rate.

Brief Description: Ensuring employers do not evade their contribution rate.

Sponsors: Senators Kohl-Welles, Parlette and Kline; by request of Employment Security

Department.

Brief History:

Committee Activity: Labor, Commerce, Research & Development: 1/26/06 [DPS]

SENATE COMMITTEE ON LABOR, COMMERCE, RESEARCH & DEVELOPMENT

Majority Report: That Substitute Senate Bill No. 6359 be substituted therefor, and the substitute bill do pass.

Signed by Senators Kohl-Welles, Chair; Franklin, Vice Chair; Parlette, Ranking Minority Member; Brown, Hewitt, Honeyford, Keiser and Prentice.

Staff: Jennifer Strus (786-7316)

Background: The unemployment insurance system is a federal/state program under which employers pay contributions to fund unemployment compensation for unemployed workers. These payments are made under state unemployment tax acts (SUTA) and the Federal Unemployment Tax Act (FUTA). The FUTA allows the states' employers to receive a tax credit against their federal unemployment tax, and the state receives a share of the FUTA revenues for administration of its unemployment insurance system, only if the state maintains an unemployment insurance system in conformity with federal law. Washington's program is administered by the Employment Security Department (ESD).

In August 2004, the federal "SUTA Dumping Prevention Act of 2004" (SUTA Dumping Act) was enacted. According to the United States Department of Labor, this law is intended to: (1) address a concern that some employers and financial advisors were finding ways to manipulate state experience rating systems so that these employers could pay lower SUTA taxes than their unemployment experience would otherwise allow; and (2) prohibit the following two methods of SUTA dumping: An employer escapes high experience rates by setting up a shell company with a lower tax rate and then transferring some or all of its workforce to the shell company; an entity starting business purchases an existing business with a tax rate that is lower than the new business tax rate. Typically, the new business ceases the business activity of the transferred business.

Under the SUTA Dumping Act, the states' unemployment insurance laws must be certified as in conformity with the SUTA dumping requirements by a certain date. For Washington, this requirement will apply beginning with the 2006 tax rate year. Among other things, the federal

Senate Bill Report - 1 - SB 6359

SUTA Dumping Act requires the states' unemployment insurance laws to: require mandatory transfer of experience when there is substantial common ownership, management, or control of two employers, and one of these employers transfers all or part its business to the other; prohibit transfers of experience, and instead assign a new employer rate, when a person who is not an employer acquires an existing employer, and the acquisition was solely or primarily for the purpose of obtaining a lower contribution rate; adopt meaningful civil and criminal penalties for persons who knowingly violate or attempt to violate these requirements; and establish procedures for identifying SUTA dumping.

Most employment in the state is covered for unemployment insurance. Each covered employer is required to pay contributions on a percentage of his or her taxable payroll, except for certain employers who reimburse the ESD for benefits the agency pays to these employers' former workers. Covered employment includes personal services performed for a third party under a contract with a temporary services agency, employee leasing agency, or other similar entity. If the entity is responsible for paying wages to the employees, then that employment is deemed to be employment for the entity.

For most covered taxable employers, unemployment insurance contribution rates are determined by the combined rate assigned to the employer based on layoff experience, social costs, and solvency surcharge, if any. The highest contribution rate varies but may not exceed 6.5 percent plus a solvency surcharge, if any.

Some covered taxable employers are not qualified to be assigned a combined rate. These unqualified employers include employers who are new employers and certain successor employers who were not employers at the time of acquiring a business. Until a new employer becomes a qualified employer, the rate is the average industry rate, plus 15 percent of that amount, with a 1 percent minimum rate. For a successor employer who was not an employer at the time of the business transfer, the rate is the rate assigned to the predecessor new employer rate in that industry.

Legislation adopted in 2003 changed the rate determination for certain successor employers engaging in a business transfer on or after January 1, 2005. If a new successor employer has substantial continuity of ownership or management of the predecessor's business, the successor is not permitted to use the new employer rate. Instead, these employers must pay at the rate assigned to the predecessor employer, and will have the experience of the predecessor employer transferred to the successor as part of its rate beginning in January following the transfer.

The 2003 legislation added a penalty for an employer that is delinquent in paying unemployment taxes because of an intent to evade the successorship requirements and for any business that promotes such evasion. This penalty was modified in 2004 to require assigning these employers, or other persons violating this requirement, the highest contribution rate, plus 2 percent, for that calendar year in which the Commissioner makes the penalty determination.

It is a gross misdemeanor, with a fine of up to \$5,000 and/or up to one year in prison, if a person who is required to collect and pay unemployment contributions willfully fails to pay the contributions or wilfully attempts to evade payment.

Senate Bill Report - 2 - SB 6359

Summary of Substitute Bill: If ESD determines that a significant purpose of transferring a business was to obtain a reduced array calculation factor rate, then one of two actions may occur:

If the successor was an employer at the time the transfer occurred, then the experience rating accounts of all employers are combined into a single account and the employers are assigned the higher of the predecessor or successor array calculation factor rate which takes effect the date of the transfer; or if the successor is not an employer at the time the transfer occurs, then the experience rating account of the acquired business cannot be transferred to the successor and, instead, a new employer rate is assigned.

If ESD assesses a delinquency against an employer, and the delinquency or a part of it is due to an intent to knowingly evade the successorship provisions, then for the rate year in which the Commissioner assesses the delinquency and for the following three rate years, the Commissioner must assign to the employer and to any business knowingly promoting the evasion of successorship provisions, a civil penalty assessment rate in addition to the assigned rate that increases the array calculation factor rate for that rate year to the maximum plus 2 percent, which total rate is not limited by any maximum array calculation factor rate.

The employer may also be criminally prosecuted. An employer subject to the civil penalty assessment must also pay the reasonable costs of auditing the employer's books and collecting the penalty.

A person, not an employer, who knowingly evades, knowingly attempts to evade, or knowingly promotes the evasion of the successorship provisions is subject to a civil penalty of \$5000 per occurrence. The person must also pay the reasonable costs of auditing the employer's books and collecting the penalty.

Beginning the January 1st after the transfer occurs, the successor's contribution rate for each rate year will be based on an array calculation factor rate that combines the successor's experience with payrolls and benefits and any experience assigned to the predecessor involved in the transfer. If only a portion of the business was transferred, then the experience attributable to the acquired portion is assigned to the successor if the successor is a "qualified employer," by including the transferred experience. If the successor is not a "qualified employer" the contribution rate will equal the sum of rates determined by the Commissioner as well as the transferred experience.

Beginning the January 1st after the transfer occurs, the predecessor's contribution rate or the array calculation factor rate mustl be based on its experience with payrolls and benefits excluding the experience of the transferred business or portion of the business transferred.

Substitute Bill Compared to Original Bill: The purpose for which the transfer occurred is changed to a "significant" purpose rather than just "a" purpose. The calculation of the civil penalty assessment rate is clarified by specifying the calculations, referring to the sum of the two calculations as the total rate, and adding that the total rate is not subject to any maximum array calculation factor rate. The definition of "transfer of a business" is clarified by adding that it includes an acquisition of substantially all or a portion of the operating assets, which may include the work force.

Appropriation: None.

Fiscal Note: Available.

Committee/Commission/Task Force Created: No.

Effective Date: The bill contains an emergency clause and is to be applied retroactively to January 1, 2006.

Testimony For: The unemployment insurance system is a closed system so that when an employer does not pay his or her unemployment taxes, the employers who do pay their taxes shoulder the burden. If the legislature does not pass this bill, as required by federal law, employers could lose up to \$1 billion in FUTA credit and ESD could lose \$88 million in administrative costs. This bill takes care of the shell entities and the sham transactions but not the professional employee organizations. The civil penalties are too low. An average SUTA dumping case, according to a GAO report, is \$634,000 in evaded taxes. SUTA dumping destroys the experience rating system and creates more socialized costs to be borne by employers who do pay their taxes.

Testimony Against: None.

Testimony Other: The first section of the bill, which reads that "a purpose" of the transfer was to lower taxes, broadens federal law and could affect innocent employers.

Who Testified: PRO: Karen Lee, Commissioner of Employment Security Department; Annette Copeland, ESD; Jeff Johnson, WSLC; Jan Gee, Washington Staffing Association/Washington Retail Association; Gary Smith, Independent Business Association.

OTHER: Mellani McAleenan, AWB; Rick Slunaker, AGC.